

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Refer Reply To:

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Date:

January 11, 2002

**LEGEND:**

X =  
Properties =

City =

D1 =

D2 =

\$x =

\$y =

Dear :

This letter responds to a letter dated November 6, 2000, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X was incorporated in Year 1 and elected under § 1362(a) to be an S corporation effective D1. X has accumulated earnings and profits.

X is in the business of owning, operating, and managing Properties, which are commercial rental real estate located in City. Through its two employees, X provides various services in operating Properties. Services X provides include: providing maintenance for common areas (snow removal, ice control, cleanup, lamp replacement, landscaping, parking lot repair and stripping); providing emergency contact source and

access for all public safety purposes; and inspecting and maintaining the Properties' foundations, exterior walls, plumbing systems, electrical systems, HVAC systems, fire alarms, and sprinkler systems.

In addition to the services X provides to tenants, X performs the usual activities involved in managing real estate. These activities include: searching for prospective tenants; negotiating and preparing the documents for all leases and lease renewals; negotiating with and appearing before governmental bodies to secure zoning, environmental, and occupancy permits; supervising all rent payments and deposits; and enforcing compliance with all lease obligations. In the fiscal year ending D2, X accrued \$x in rents and incurred \$y in relevant expenses.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under § 1362(d)(3)(A) shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from Properties is income from the active trade or business of renting property and is not passive investment income as described in § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion on whether X is eligible to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,  
J. THOMAS HINES  
Chief, Branch 2  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes